

M. IRC 501(c)(15) - THE BLITZ SINCE '86

by

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1. Introduction

Before the Tax Reform Act of 1986 ("1986 Act"), IRC 501(c)(15) provided for the exemption of mutual insurance companies if their gross receipts for the taxable year did not exceed \$150,000.

The 1986 Act liberalized IRC 501(c)(15) in two important respects. It allowed stock companies to qualify for exemption as well as mutual insurers in an attempt to create parity between stock and mutual insurance companies, and it changed the measure of the dollar ceiling from a gross-receipts test to a premium-income test. (The changes are discussed in more detail in the 1989 CPE text at pp. 167-172.)

IRC 501(c)(15) now provides that insurance companies (other than life) are exempt from federal income tax if their net written premiums (or if greater, direct written premiums) for the taxable year do not exceed \$350,000. Premiums from all members of the taxpayer's controlled group (as defined in IRC 1563, with modifications) are aggregated for purposes of the \$350,000 test.

These changes were followed by a dramatic increase in the number of IRC 501(c)(15) applicants. Some of these organizations underwrite or reinsure only the risks of their corporate parents; sell prepaid service contracts or warranties in connection with sales of products; appear to be formed for little other than tax avoidance purposes; and some no longer sell new insurance contracts but are in a posture of winding up the business and liquidating.

This article will present an overview of significant areas that have arisen as a result of the liberalization of IRC 501(c)(15) in the 1986 Act. First, it will discuss what an insurance contract is and why captives and extended service contracts/warranties are a problem in the area. Second, it will discuss what an insurance company is, the requirements for a company to be respected by the Service as a separate legal entity and not disregarded as a sham for tax avoidance, and the problem of companies in liquidation. Third, it will discuss the \$350,000 test, and the related areas of IRC 845 and 1563. Fourth, it will briefly discuss the life insurance company prohibition. An appendix summarizing the key points

discussed appears at the end of the article.

2. What is an "Insurance Contract"?

A. Background

In order to qualify for recognition under IRC 501(c)(15), an organization must be an insurance company. An insurance company must be in the business of issuing insurance contracts. Neither the Code nor the regulations defines an insurance contract. Case law provides, however, that an insurance contract must shift and distribute a risk of loss, and that the risk must be an "insurance" risk (insurance risks are discussed in the section below on service contracts).

The foundation for this analytical framework is the landmark case of Helvering v. LeGierse, 312 U.S. 531 (1941), in which the Supreme Court held that insurance involves risk shifting and risk distributing. In LeGierse, an individual purchased "life insurance" and "annuity" contracts from an insurance company. The individual's sole objective was to reduce estate taxes; the insurance company was not at risk of losing any more funds than it received, except perhaps through its own bad investments with those funds. The court held that the proceeds from the contracts were not insurance proceeds because the contracts viewed together did not transfer an insurance risk, and stated that insurance payable to specific beneficiaries is designed to shift to a group the risk of loss insured against.

B. Risk Shifting and Risk Distributing

The Service currently makes a sharp distinction between risk shifting and distributing. Simply put, risk shifting requires that a risk pass away from the insured to the insurer. Risk distributing requires the pooling by the insurer of a number of independent risks. The area of what constitutes risk shifting and distributing, especially with regard to "captives," is in a state of flux, as evidenced by the recent cases and Revenue Rulings discussed below.

Along the lines of LeGierse, the rule is well established that a business cannot set aside a fund as an "insurance" reserve and claim a business expense deduction for insurance premiums paid under IRC 162 and Reg. 1.162-1(a); "self insurance" arrangements do not involve risk shifting or distributing and, therefore, are not insurance. See, e.g., Rev. Rul. 60-275, 1960-2 C.B. 43. The rule applies even if the segregated fund is administered by an independent agent. For instance, the court in Steere Tank Lines, Inc. v. United States, 577 F.2d 279 (5th Cir. 1978),

found no insurance where premiums received from the taxpayer could only be used to pay claims on the taxpayer's account.

Risk shifting issues frequently arise in the case of captive insurers. In Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987), the court defined a "captive" as

a corporation organized for the purpose of insuring the liabilities of its owner. At one extreme is the case presented here, where the insured is both the sole shareholder and only customer of the captive. There may be other permutations involving less than 100% ownership or more than a single customer, although at some point the term "captive" is no longer appropriate.

When there is a captive insurer involved, the insured, who is also the shareholder, may ultimately bear the losses incurred by its captive. In Rev. Rul. 77-316, 1977-2 C.B. 53, the Service addressed whether a subsidiary which "insured" the risks only of its parent and the parent's other subsidiaries was an insurance company for tax purposes. Another issue addressed was whether the parent and its other subsidiaries were entitled to a business expense deduction under Reg. 1.162-1(a) for payment of "insurance" premiums. A third issue was the proper characterization of the payments from the parent corporation and subsidiaries to the insurance subsidiary, from the perspective of the insurance subsidiary (income vs. capital contributions).

In Rev. Rul. 77-316, the Service ruled, in three situations, that the contractual arrangement between the domestic parent and subsidiaries and the "insurance" subsidiary did not qualify as insurance for federal income tax purposes. In Situation 1, a parent corporation and its subsidiaries paid amounts as insurance premiums directly to an "insurance" subsidiary. In Situation 2, the premiums were paid to an unrelated insurance company, and the parties agreed that the unrelated company would immediately transfer 95% of the risks under a reinsurance agreement to the "insurance" subsidiary. In Situation 3, the parent and subsidiaries paid premiums to the "insurance" subsidiary, with the understanding that it would transfer 90% of the risk through reinsurance agreement to an unrelated insurance company. In each situation, the "insurance" subsidiary insured no other parties and was wholly owned by the parent.

The Service recognized each "insurance" subsidiary as an independent corporate entity under Moline Properties, Inc. v. Commissioner, 319 U.S. 436

(1943), in view of its business activity. The Service concluded, however, that the economic reality of the situation was that the "insurance agreement" with each subsidiary was designed to obtain a deduction for the parent and its other subsidiaries by indirect means that would be denied if sought directly (with a fund set aside for self-insurance). The parent, its "insurance" subsidiary, and its other subsidiaries, though separate corporate entities, represented one economic family, with the result that those who bore the ultimate economic burden of loss were the same persons who suffered the loss. Thus, there was no economic shifting or distributing of risk of loss to the extent that the risks were not retained by an unrelated insurance company. Because the payments were not insurance premiums, the Service ruled that the "insurance" subsidiary conducted no insurance business and was not an insurance company; the payments by the parent and the other subsidiaries were not deductible as business expenses for insurance premiums; the payments were not income to the "insurance" subsidiary from the conduct of a business, but were capital contributions; and payments from the "insurance" subsidiary were dividends to the extent of its earnings and profits.

Taxpayers, relying on Moline Properties (supra), have argued that any transfer between separately-incorporated entities involves a shift of risk and that the ownership relationship between insured and insurer is irrelevant. In Moline Properties, a corporation was formed for the valid business purpose of holding title to real property. The property was sold, and the incorporator deposited the proceeds into his personal bank account. The incorporator argued that the sale proceeds should be considered income to him rather than to the corporation, and that the corporation should be disregarded. The Supreme Court held that a corporation is a separate taxable entity and that those who use the corporate form must accept the disadvantages. The corporate form is not to be disregarded except where it is a sham or unreal, as where the corporate purpose is not the equivalent of business activity or is not followed by the carrying on of business by the corporation.

In contrast to Rev. Rul. 77-316, Rev. Rul. 78-338, 1978-2 C.B. 107, provided a situation in which "insurance contracts" existed. A domestic corporation owned an interest along with 30 unrelated shareholders in a foreign corporation which insured the risks of its shareholders and their subsidiaries and affiliates. No shareholder owned a controlling interest, and no shareholder's individual risk exceeded 5% of the total risks insured. The Service ruled that because the shareholders were not economically related, the economic risk of loss could be shifted and distributed among the shareholders who comprised the insured group. The amounts paid to the foreign corporation were deductible under

IRC 162.

In Rev. Rul. 88-72, 1988-2 C.B. 31, as clarified by Rev. Rul. 89-61, 1989-1 C.B. 75, the economic family analysis was used to find a lack of risk shifting even where most of the wholly-owned subsidiary's business was with unrelated insureds. The Service ruled that while there may have been sufficient risk distribution, there was no risk shifting between the parent (and its subsidiaries) and the "insurance" subsidiary. The Service reasoned that the parent's wealth rises and falls with the wealth of its subsidiaries, dollar for dollar, since the parent owns the subsidiaries.

Rev. Rul. 88-72 also explained the distinction between risk shifting and distributing. Risk shifting occurs where a risk is shifted away from a corporate parent and its subsidiaries. Risk distributing occurs where an insurance company accepts a large number of independent risks, and thereby takes advantage of a statistical phenomenon known as "the law of large numbers"--although the potential loss exposure increases, the average loss incurred becomes increasingly predictable. The Service rejected Tax Court dicta suggesting that the presence of third-party insureds might under certain circumstances produce the requisite risk shifting.

It does not appear that the economic relationship between the insurer and insured is relevant for risk distribution purposes, as long as the risks are independent. For instance, a single oil company might pay its captive insurer premiums for casualty insurance on a number of oil wells throughout the world, and thus distribute its risk of loss for any particular well. Conversely, if fifty 2% co-owners of a single well each pay premiums to the same company and the company insures no other risks, then it has not distributed risk.

C. Economic Relationship Cases

A number of cases in the wake of Rev. Rul. 77-316 involve the issue whether amounts paid to a captive insurer are deductible, which entails the issue whether the contracts are "insurance" contracts. Some of the fact patterns are virtually indistinguishable from those in Rev. Rul. 77-316. In such cases the courts have usually upheld the government's position that such contracts are not insurance, usually with reasoning similar to that found in the Revenue Ruling, although no court appears to have expressly adopted the economic family doctrine. See, e.g., Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981), cert. denied, 454 U.S. 965; Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th

Cir. 1985); Beech Aircraft Corp. v. United States, 797 F.2d 920 (10th Cir. 1986); and Clougherty Packing Co., *supra*. In rejecting the Moline Properties argument that premium payments between separately incorporated entities necessarily entail risk shifting, the courts have regarded insurance as a unique risk transfer device unlike other transfers between related corporations. See Mobil Oil Corp. v. United States, 8 Cl.Ct. 555 (1985); cf. Clougherty Packing Co., *supra*.

However, some courts based their decision, in whole or part, on another factor--the insured parent's guarantee to unrelated primary insurers of the performance of the reinsurance subsidiary. Gulf Oil Corp. v. Commissioner, 914 F.2d 396 (3rd Cir. 1990); Carnation Co., *supra*; Stearns-Roger Corp., *supra*. Also, the Sixth Circuit overruled the Tax Court in favor of the taxpayer parent with regard to the parent's payment of premiums on behalf of its subsidiaries, finding such payments to be deductible insurance premiums, although the Tax Court's finding that the parent's payments on its own behalf were not insurance premiums was upheld. Humana Inc. and Subsidiaries v. Commissioner, 88 T.C. 197 (1987), *affirmed in part and reversed in part sub nom Humana Inc. v. Commissioner*, 881 F. 2d 247 (6th Cir. 1989). The Service makes no such distinction. The Tax Court pointed out that the rule is easily avoided if not applied to a company insuring its brother or sister company. *Id.*, 88 T.C. at 213-14.

Taxpayers have won several cases on fact patterns falling between those of Rev. Rul. 77-316 and Rev. Rul. 78-338. Several courts have held, contrary to Rev. Rul. 88-72, that substantial insurance business with unaffiliated insureds creates a pool allowing for risk shifting as well as risk distribution with regard to premium payments by a parent to its insurance subsidiary. See Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135 (Fed. Cir. 1993) (44-66% unaffiliated business); AMERCO, Inc. v. Commissioner, 979 F.2d 162 (9th Cir. 1992) (52-74% unaffiliated business); The Harper Group v. Commissioner, 979 F.2d 1341 (9th Cir. 1992) (29-33% unaffiliated business); and Sears, Roebuck and Co. v. Commissioner, 972 F. 2d 858 (7th Cir 1992) (99% unaffiliated business). By contrast, the lower court in Gulf Oil Corp., *supra*, considered 2% unaffiliated business *de minimis* and insufficient to constitute insurance. Also, premium payments were held deductible in Crawford Fitting Co. v. United States, 606 F.Supp. 136 (N.D.Ohio 1985), where the insurer was mainly owned not by the premium-paying corporation but by corporations owned by the sole shareholder of the paying corporation and his wife and daughter, and where unrelated parties were the named insureds for about 70% of the insurance. The Service is currently considering how to respond to these court decisions.

In Sears, the 7th Circuit even questioned whether risk shifting is a necessary element of insurance. Assuming the continued validity of the economic family concept, one question is when to apply it. Is it applied only when the parent entity is a corporation? The reasoning does not suggest that it matters whether the "parent" of the economic family is an individual, corporation, or other entity. Is it applied only where the parent wholly owns the subsidiary? Where the parent and other related entities do not wholly own the "insurance" subsidiary, there would appear to be some risk shifting by their premium payments, to the extent of the outside ownership.

Rev. Rul. 77-316 treats the transfers within the economic family as capital contributions rather than business income. Thus, in applying the 50% test for an insurance company under Reg. 1.801-3(a) and IRC 816 (discussed further below), such transfers are disregarded--they are neither part of the insurance business, nor any other business. However, two courts that sustained the Service's disallowance of the deduction for "premiums" paid did not go along with the Service's "contribution down/dividend up" approach, and suggest that the amounts paid as "insurance premiums" may be considered nondeductible compensation for risk management services. See Mobil Oil Corp., 8 Cl. Ct. at 568; Gulf Oil Corp., 914 F. 2d at 413.

Another issue is whether a single reinsurance agreement provides for adequate risk distribution on the part of the reinsurer. The issue arises regardless of whether the insurer and reinsurer are economically related. Reinsurance agreements can be structured many different ways with regard to what is being reinsured: e.g., X% of the liability on each insurance contract, or X% of total liabilities in excess of \$Y incurred in a given year. However, a reinsurance agreement typically transfers some or all of the insurer's liability under its insurance contracts. Thus, it is necessary to look at the risk pool of the primary insurer to determine whether there is adequate risk distribution. If so, then a reinsurer which reinsures some portion of the primary insurer's liability and nothing else also adequately distributes risk. The court in Alinco Life Ins. Co. v. United States, 373 F.2d 336 (Ct.Cl. 1967), held that a company which had a single reinsurance agreement with a primary insurer to reinsure 18% of its credit life insurance risks was a life insurance company.

Given the state of the law, IRS Chief Counsel ordinarily will not rule on whether the risk shifting and distribution necessary to constitute insurance are present for purposes of determining if a company is an "insurance company" under Reg. 1.801-3(a), unless the facts are within the scope of Rev. Rul. 77-316 or

78-338. Rev. Proc. 93-3, 1993-1 I.R.B. 71, 4.41.

As the above cases indicate, it is necessary to develop a picture of all the insureds, insurers, and reinsurers, and the relationships between them and the IRC 501(c)(15) applicant, in order to determine whether there is adequate risk shifting and distributing.

D. Service Contracts and Sellers' Warranties

Not all contracts that shift and distribute risk qualify as insurance contracts. Most contracts may be viewed as shifting a risk of some sort, but to qualify one as an insurance contract, the risk underwritten or reinsured must be an "insurance" risk. See Helvering v. LeGierse, *supra*.

A major portion of the increase in IRC 501(c)(15) exemption applications since 1986 can be attributed to companies that insure or reinsure auto service warranties and rustproofing/chemical protection contracts. The question arises whether such contracts between auto buyers and dealers are "insurance" contracts. There are two schools of thought that argue such contracts are not insurance contracts--a service contract rationale and a seller's warranty rationale.

The service contract rationale applies where the primary purpose of the contract is service rather than indemnification, when benefits are provided in the form of services. Rev. Rul. 68-27, 1968-1 C.B. 315, held that an HMO-type organization was not an insurance company. Most of its activities involved preventive care and care for the injured and sick by a salaried staff of medical personnel at a clinic; the rest involved reimbursement of expenses incurred by outside medical organizations. The Service reasoned that there was no hazard or peril insured against with respect to the preventive care. Regarding the care for the injured and sick, the Service held that the risk assumed by the organization was predominantly a normal business risk of an organization which furnished medical services on a fixed-price basis rather than an insurance risk. Some insurance risk was assumed, but such assumption was a minor part of the contract.

The seller's warranty rationale applies in the case of a warranty of a product by a product seller. Insurance law generally provides (although there are contrary cases) that where the warranty does not protect against outside perils but only against inherent product defects, the warranty is not an insurance contract:

A written warranty representing that the articles sold are so well and

carefully manufactured that they will give satisfactory service under ordinary usage for a specified length of time, and providing for an adjustment in the event of failure from faulty construction or materials, but expressly excluding happenings not connected with imperfections in the articles themselves, is not a contract substantially amounting to insurance within the meaning of such a statute.

Couch on Insurance 2d, 1:15 (1984), citing State ex rel. Herbert v. Standard Oil Co., 138 Ohio St. 376, 35 N.E.2d 437 (1941). See, e.g., GAF Corp. v. County School Board of Washington County, 629 F.2d 981 (4th Cir. 1980) (agreement by a supplier of roofing materials to repair certain damage to a roof caused by faulty workmanship, which was a peril unrelated to defects in the material sold, was a relatively unimportant part of what was essentially a warranty agreement accompanying the sale of goods, and thus the warranty was not an insurance contract).

The typical auto service warranty or extended service contract involves a promise to repair or replace defective items rather than to reimburse financial losses. The warranty/service contract only covers breakdowns of covered parts due to defects in materials or workmanship, and specifically excludes losses resulting from outside perils (e.g., a flood or collision). Such contracts may be viewed as other than insurance contracts.

Even if a service contract or warranty is not an insurance contract, an insurer's agreement to indemnify the issuer of the service contract or warranty may be an insurance contract. In TAM 9251007, a contract to indemnify another for the cost of repairs in honoring a service contract was deemed an insurance contract. Under the facts, auto dealers sold service contracts to auto buyers for repair services in addition to the manufacturer's warranty. The dealers then purchased "policies" from a subsidiary of the manufacturer for reimbursement of the dealers' costs to repair or replace auto parts pursuant to the service contracts. The subsidiary reinsured a portion of its business relating to the policies with parties related to the dealers. The situation is diagrammed below:

- auto buyer
 - (service contract)
- auto dealer
 - (policy)
- manufacturer's sub
 - ("reinsurance" agreement)
- dealer-related entity

The Service concluded that the policies between the auto dealers and the manufacturer's sub were "insurance contracts." The Service noted, however, that the "reinsurance" between the manufacturer's subsidiary and the parties related to the dealers might not be insurance due to insufficient risk shifting and distributing (see the discussion above on captives).

Sometimes the dealer does not issue the warranty but merely sells the warranty as an "agent" for an independent insurer. If the independent insurer "reinsures" its risk with a company related to the dealer, such as a subsidiary of the dealer, there appears to be no self-insurance problem as long as the dealer does not pay the premium and does not bear the risk of loss under the warranty in the first place. Also, the reinsurance arrangement looks less like self-insurance (and more like Rev. Rul. 78-338, supra) as more dealers own a part of the reinsurer and do business with it. In this situation, one issue is whether the dealer is truly an agent of the independent insurer. Another is whether the dealer-related entity is a sham company, as discussed below.

3. What is an "Insurance Company"?

A. Definition

In order to qualify for recognition of exemption under IRC 501(c)(15), an organization must be an "insurance company or association." "Insurance company" has the same meaning in IRC 501(c)(15) as in subchapter L of the Code, which regulates the taxation of such companies. See Rev. Rul. 74-196, 1974-1 C.B. 140.

In the Deficit Reduction Act of 1984, subchapter L was substantially revised. As part of this revision, IRC 801 was redesignated as IRC 816 and amended. IRC 816(a) defines an insurance company for life insurance purposes as any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by

insurance companies. Reg. 1.801-3(a)(1), promulgated under the statutory predecessor of IRC 816, contains an identical definition except that it uses the phrase "primary and predominant business activity" instead of "more than half of the business." To the extent that the definitions differ, the new statute presumably controls for insurance companies generally. While new regulations under IRC 816 have not been issued, the Senate Committee Print provides that in the absence of contrary guidance, the regulations, rulings, and case law prior to the 1984 Act are to serve as interpretive guidelines. S. Prt. No. 98-169, Vol. I, 98th Cong., 2nd Sess. 524 (1984). Thus, Reg. 1.801-3(a)(1) is still useful as guidance.

Rev. Rul. 68-27, 1968-1 C.B. 315, provides that the meaning of the term "insurance company" as defined in Reg. 1.801-3(a) is equally applicable to insurance companies other than life. Therefore, our reliance on Reg. 1.801-3(a)(1) and IRC 816(a) in defining a nonlife insurance company is also appropriate.

The regulation also makes clear that state law characterization of insurance companies (and insurance contracts, by analogy) is not controlling for federal tax purposes. See Rev. Rul. 71-404, 1971-2 C.B. 260.

Because over half of an insurance company's business must be issuing insurance contracts or reinsuring risks, captives and sellers of service contracts and warranties run into problems where all or most of their contracts issued are not properly characterized as insurance contracts. Sham companies, discussed below, do not satisfy the requirement of being an entity with a business purpose which should be respected by the Service.

Another problem area regarding the definition of an insurance company is companies in liquidation or rehabilitation. Such companies do legitimate business, but the question is whether over 50% of such business is issuing insurance or annuity contracts or reinsuring risks.

B. What is a Company?

(1) Recent IRC 501(c)(15) Applicants

IRC 501(c)(15) organizations must be "companies or associations." "Company" is not defined in the Code or regulations. However, an objective to carry on business for profit is an essential characteristic of all organizations engaged in business for profit. See Reg. 301.7701-2(a)(2). If an organization neither is organized to carry on a business nor in fact conducts one, then the

Service need not respect it as an entity for tax purposes. See, e.g., Moline Properties, supra, which stated in dicta that the corporate form may be disregarded where it is a "sham" or "bald and mischievous fiction."

A number of companies claiming exemption under IRC 501(c)(15) reinsure prepaid auto service warranties, chemical protection contracts, and credit life and disability insurance contracts. Such contracts are usually sold in conjunction with a loan or the sale of a big-ticket item, particularly autos. Purchases of such contracts are often "impulse" purchases rather than planned by the consumer, and the sales tend to be highly profitable for the sellers. While the contracts often involve a third-party insurance company (known as a fronting company), dealers are in a position to make the sales and demand a proportionate share of the profits. However, rather than be taxed on the profits from these contracts at the usual corporate rates, dealers often divert the profits to a related reinsurance company which reinsures most of the fronting company's liability. In the past, such companies reinsured credit insurance and sought the tax advantages of life insurance company status, particularly deferral of taxation of unearned premiums. Post-1986, many companies seek the greater tax advantages of IRC 501(c)(15) status: exemption from tax of all premium and investment income.

The fronting company has little need for the reinsurance from an actuarial standpoint. See Alinco, supra. All acts of earning the premiums occur at the dealership, where the policy is sold, or at the fronting company, where the claims are processed. The dealer might merely have taken a higher commission or retroactive rate credits from the fronting company, but for the desire to reduce corporate taxes by shifting income to the reinsurer. While the reinsurer observes many of the formalities of a reinsurance company (e.g., entering into a reinsurance agreement, holding a reserve account) and thus is arguably "doing business," it is questionable whether the reinsurer has a substantial purpose to do anything other than minimize the federal taxes owed on income earned by its related dealerships. It is doubtful that Congress had such organizations in mind when it amended IRC 501(c)(15) in 1986 to include stock corporations.

Many applications involve the following pattern. One or more auto dealers issue the prepaid contracts. The dealer then purchases a policy from a fronting company (a legitimate domestic insurance company) to underwrite all of the dealer's liability. Alternatively, the dealers may sell the contracts as agents for the fronting company (for which the dealers may receive a commission) and forward the premium to the fronting company. The fronting company keeps the premiums necessary to underwrite the risk and an administrative fee, and passes the

remaining premiums on to the captive reinsurer, by prearrangement with the dealers. Additional players in this scenario may include an "administrator" of the service contracts and credit policies, and a reinsurance company between the primary insurer and the captive reinsurer.

Frequently, the reinsurance company seeking exemption is a foreign corporation, incorporated "offshore" in a tax haven jurisdiction (under Rev. Rul. 66-177, 1966-1 C.B. 132, foreign incorporation generally does not disqualify an organization from exemption under IRC 501). There is frequently little insurance regulation (such as minimum reserve requirements) of companies in the tax haven jurisdiction, and taxes are minimal. The offshore reinsurer is owned by the dealers, or the dealers' owners, officers, or directors. Sometimes the transaction begins before the dealers have set up an offshore reinsurer, in which case the fronting company agrees to "warehouse" or hold the funds (sometimes called the "delta" or "administrative" reserve) until the reinsurer is created.

The foreign reinsurer is usually foreign only in place of incorporation. Its place of business is often the dealership. It may have no paid employees and no property of its own other than a bank account and a ledger. Foreign reinsurers have been known to hire a company to pretend to be their place of business and receive communications for their officers, in order to create the appearance that they have an office separate from the related dealerships. Such characteristics are typical of sham companies. See Shaw Constr. Co. v. Commissioner, 35 T.C. 1102 (1961), aff'd, 323 F.2d 316 (9th Cir. 1963); Aldon Homes, Inc. v. Commissioner, 33 T.C. 582 (1959). See also Kimbrell v. Commissioner, 371 F.2d 897 (5th Cir. 1967) (regarding the corporation's execution of contracts, hiring of employees, filing of tax returns, negotiation of loans, and collection of interest on the loans as empty gestures, where the employees performed no services and the corporation no sales activity); Harbour Properties, Inc. v. Commissioner, T.C.M. 1973-134 (disregarding the corporation's maintenance of the corporate books and bank account, payment of office rent, and filing of a tax return).

Although the reinsurer asserts that it holds a reserve fund for the payment of insurance claims and invests the funds, in some situations no claim upon the reserve fund is ever made--all claims are processed and paid by the fronting company with current premiums. The reinsurer is, in effect, merely a holding company or bank account of the dealers, holding the profits from the sale of the credit insurance or warranties and making distributions to its shareholders, sometimes in the form of "loans" which are never repaid.

The unrelated insurance company sometimes charges the dealership a fixed amount (e.g., \$100) for each contract sold to a customer. The dealership may charge the customer much more than that (e.g., \$1000) in selling the service contract. Often the dealership takes no commission and forwards the full \$1000 to the unrelated insurer, but the reinsurance agreement characterizes only the \$100 as the "premium." The reinsurance agreement provides for the unrelated insurer to retain a certain percentage of the liability and a certain percentage of the \$100 premium (e.g., \$50), and to pass on the remaining liability and \$950 to the reinsurer. Under the terminology used in such agreements, it appears that the reinsurer has \$50 in premiums and \$900 of uncharacterized income.

(2) Business Purpose Cases

Organizations that fit the pattern just described may be regarded as sham corporations and denied IRC 501(c)(15) status. In the consolidated case of Wright v. Commissioner, U.S.T.C. Docket Nos. 1000-90, 18407-90, 27968-90, and 26402-91, the Service is seeking, among other things, to treat certain reinsurers as sham corporations, conducting no business and having no purpose other than sheltering their shareholders' income. (In the alternative, the Service seeks to treat the reinsurance arrangement as self-insurance by the dealership as discussed above, and to recharacterize the income under IRC 845(a) or 482 as earned by the dealership, as discussed below.)

Cases involving sham companies are particularly fact-sensitive and thus are difficult to summarize briefly. However, courts are more likely to regard insurers as shams where they do not abide by their written agreements with others in their financial transactions. Also, the courts are more likely to respect a reinsurer as an entity where state law prohibits the dealer from directly engaging in the business of insurance, or from receiving commissions or retroactive rate credits on the sale of insurance (although the reinsurer's existence may thwart the purposes of the state law).

The taxpayer prevailed in Alinco Life Insurance Co. v. United States, 373 F.2d 336 (Ct. Cl. 1967), which held that a reinsurer of credit life and disability insurance owned by the seller of the insurance qualified as an insurance company. The seller, an auto finance company, was prohibited by state law from engaging directly in the insurance business. The court reasoned that the reinsurer assumed substantial risks, for which it was legally required to maintain reserves backed by a substantial deposit of securities with the state insurance regulator. The court considered the reinsurer's simple operation and lack of operating expenses of little

consequence, finding that the primary insurer typically does all the work. The court also rejected the argument under IRC 269 (which disallows tax benefits arising from corporate acquisitions that are made principally for tax avoidance) that the primary purpose for the reinsurer was tax avoidance. The court reasoned, in part, that while the primary insurer had no pressing actuarial need to reinsure, it had to reinsure as a practical matter in order to maintain its business with the seller, which might otherwise have moved its business elsewhere given the business climate. The primary insurer was unwilling to increase its rates of commission to the seller. The court also found that the seller was financially better off forming the reinsurer regardless of the tax advantages as a life insurance company.

In Ocean Drilling & Exploration Co. v. United States, 24 Cl.Ct. 714 (1991), aff'd, 988 F.2d 1135 (Fed. Cir. 1993), the court stated, sua sponte, that a captive insurer was not a sham, given the following facts: the insureds (both related and unrelated parties) truly faced hazards; the business underwritten was understood to be insurance; insurance contracts were written and premiums were paid; unrelated parties reinsured the captive; unrelated parties co-insured part of the direct insurance the captive wrote for its parent; premiums charged were at commercial rates; claims were investigated before paid; the captive's funds were maintained separately from its parent's funds; the captive was adequately capitalized, and its policies binding; and the captive's business operations were separate from its parent's. The captive's business was not completely separate from the parent's, however, as there were interlocking officers, directors, and employees, and the parent's approval was required for major decisions, such as operating budget and settlement of large claims. See also Commissioner v. Bollinger, 485 U.S. 340 (1988).

On the other hand, in Bail Bonds by Marvin Nelson, Inc. v. Commissioner, T.C.M. 1986-23, aff'd, 820 F.2d 1543 (9th Cir. 1987), the court ruled a "reinsurance agreement" purporting to reinsure bail bonds a sham and denied an IRC 162 deduction to the "reinsured" bonding company. The significant terms of the agreement were not carried out--payments were made arbitrarily, not in accordance with the agreed amounts and due dates; and the reinsured never provided either a statement of charges on the bonds written (which was necessary under the agreement to effectuate the reinsurer's liability), or any notice of its forfeiture losses and skip-tracing expenses. The reinsured continued reinsurance policies with other sureties during the same time. The reinsured never filed a bona fide claim against the reinsurer, and the reinsurer never reimbursed the reinsured for any forfeiture losses or expenses incurred. The reinsured's payments were

transferred through several entities and wound up in the hands of the reinsured's sole shareholder. [Incidentally, bail bonds are not considered insurance contracts, and a company which primarily acts as a surety for bail bonds is not an insurance company. See Rev. Rul. 68-101, 1968-1 C.B. 319; Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190 (7th Cir. 1978).]

The court reached the same result in F.R. Johnson Products Co. v. Commissioner, T.C.M. 1982-457, in which a parent corporation was denied an IRC 162 insurance deduction for payments to its wholly-owned insurance subsidiary. The subsidiary was never licensed to engage in the insurance business, never attempted to accumulate the necessary cash reserve, never had any profits, and did not file any tax returns for the years in issue. The record indicated that the payments sought to be deducted by the parent went into the parent's savings account rather than the subsidiary's account. Also, the parent borrowed from the subsidiary's account to purchase a forklift, and the parent's majority shareholder made withdrawals from the account for personal reasons. The court concluded that the subsidiary was not an entity separate and distinct from the majority shareholder, but was used as his reserve for self-insurance and source of funds for business and personal expenses.

While the Service may not agree with the result reached in Alinco and Ocean Drilling, the cases illustrate some of the factors the courts consider in determining whether a corporation has a substantial business purpose and carries on business activity. The issue is a factual one, determined by the facts and circumstances. Noonan v. Commissioner, 451 F.2d 992 (9th Cir. 1971). An organization claiming IRC 501(c)(15) status may be scrutinized to determine what it is actually doing, where its premiums come from, where they go, and whether it has a substantial nontax reason for being.

Such use of captive reinsurers is not new. Congress has long been aware of the potential for a company earning income on the sale of insurance policies to shift such income to a related insurance company, and considers IRC 482 available to the Service to shift the income back to the person who earns it for tax purposes:

There is a potential abuse situation in the case of the so-called captive insurance companies. It may be possible for a finance company, for example, to establish a subsidiary life insurance company that will issue life insurance policies in connection with the business of the parent. If the subsidiary charges excessive premium on this business,

a portion of the income of the parent company can be diverted to the life insurance company. It is believed that section 482 of the Internal Revenue Code of 1954 (relating to allocation of income and deductions among related taxpayers) provides the Secretary of the Treasury ample regulative authority to deal with this problem.

Sen. Rep. No. 1571, 84th Cong., 2d Sess., 1956-1 C.B. 971; H.R. Rep. No. 1098, 84th Cong., 1st Sess., 1956-1 C.B. 958. IRC 482 applies regardless of whether the reinsurer is a sham or a genuine corporation.

The Service has successfully shifted income pursuant to IRC 482 in a number of cases. However, in Commissioner v. First Security Bank of Utah, 405 U.S. 394 (1972), the Supreme Court overruled the Commissioner's IRC 482 reallocation. In that case, subsidiary banks in a corporate group were arranging credit life insurance for their borrowers with an unrelated insurance company. Banking laws were deemed to prohibit the banks from receiving sales commissions, so the insurance company paid sales commissions (customary in the industry) to a non-bank sister company. Later, the corporate group founded a reinsurance company, and had the unrelated insurance company reinsure its liability with the reinsurance company (with more favorable tax consequences) in lieu of paying commissions. The Commissioner sought to reallocate reinsurance premium income as commission income to the subsidiary banks. The court prohibited this action, reasoning that the Commissioner could not reallocate income to a person who could not legally receive it in the first place.

By analogy, a dealership which cannot legally engage directly in the insurance business and which cannot legally receive commission income in excess of a given percentage may be able to set up a reinsurance company to receive the excess proceeds from the sales of its credit policies without risk of an IRC 482 reallocation.

C. Companies in Liquidation

In recent years, as the economy weakened, many insurance companies became insolvent. When an insurance company becomes insolvent, the State Insurance Commissioner or other appointed receiver takes over the management of the insolvent company for an indefinite period to try to restore its financial health (the rehabilitation phase), or otherwise to dissolve and liquidate it (the liquidation phase). The rehabilitation and/or liquidation process, which involves gathering the assets and paying the claimants, may take several years. During the

rehabilitation, the company may be prohibited from issuing new insurance contracts, which begs the question whether its predominant activity is issuing insurance contracts. Where the company is liquidating, it is normally prohibited from accepting new claims on the existing policies, in the interest of settling and finalizing matters. Where such companies no longer receive substantial premiums and their main source of income is investment income, many meet the \$350,000 test described below and file for IRC 501(c)(15) exemption even though they may have millions of dollars in annual investment income.

The question arises whether the activity of companies in liquidation or rehabilitation is that of insurance companies, within the meaning of IRC 816(a) and Reg. 1.801-3(a)(1). For instance, in Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932), the Supreme Court held that a company was not an insurance company where its premium income constituted only about 35% of its total income. If less than half of a company's business is not properly characterized as insurance, then it is not an insurance company.

Even if a company in liquidation is an insurance company, a problem with exempting such organizations is that it appears to undermine Congressional intent that only "small" insurance companies qualify for IRC 501(c)(15) status. See H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 678 (1985), 1986-3 C.B. (Vol. 2) 678; Sen. Rep. No. 99-313, 99th Cong., 2d Sess. 512 (1986), 1986-3 C.B. (Vol. 3) 512. It is doubtful that Congress intended to exempt companies earning millions in investment income.

Nevertheless, the Service has taken the informal position that insurance companies in liquidation that do not issue insurance contracts but only administer claims may qualify as insurance companies. However, where an organization's investment activity generates more income than necessary to pay its claims, the "excess" investment activity may be viewed as non-insurance business. If over half of the organization's business is excess investment activity, then the organization is not an insurance company.

4. \$350,000 Test

In order to qualify for recognition of exemption under IRC 501(c)(15), an insurance company's net written premiums (or, if greater, direct written premiums) for the taxable year cannot exceed \$350,000.

In addition, if an organization has a short tax year, then its premiums should

be annualized (i.e., dividing the income by the number of months in the short tax year and multiplying by 12). G.C.M. 39864 (July 26, 1990).

A. Net and Direct Written Premiums

Rev. Rul. 67-80, 1967-1 C.B. 143, held that the term "premiums" as used in IRC 821 has the same meaning as for IRC 501(c)(15).

IRC 821, pertaining to mutual insurance companies, was repealed in 1986. A regulation promulgated under that section, Reg. 1.821-4(a)(1)(ii), provides some guidance for the definition of premiums. It states that the term "premiums" in IRC 501(c)(15) means the total amount of the premiums and other consideration provided in the insurance contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the terms of the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction), but does not include amounts received from other insurance companies for losses paid under reinsurance contracts. Reg. 1.809-4(a)(1), promulgated under the former IRC 809 (pertaining to gain and loss from operations of life insurance companies), provides a practically identical definition of "the gross amount of all premiums."

One may ask whether foreign source premiums should be included. The Service has taken the informal position that all premiums should be included in calculating the \$350,000 test, regardless of the domestic or foreign source of the premiums. This position is consistent with the idea that the test is intended to measure the annual amount of business of the insurance company, as well as the idea that all companies, foreign and domestic, are allowed to qualify for exemption under IRC 501, as stated in Rev. Rul. 66-177, supra.

Neither the Code nor the regulations define "net written premiums" or "direct written premiums." The Service has used as guidance the definitions found in the National Association of Insurance Commissioners' Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, 14-1 (1991). Written premiums include direct premiums, assumed reinsurance premiums, and ceded reinsurance premiums, defined as follows:

- (a) Direct written premiums = all premiums arising from policies issued by the company as the primary insurance carrier, adjusted for any return or additional premiums arising from endorsements, audits, and retrospective rating plans;
- (b) Assumed reinsurance premiums = all premiums (less return premiums) from contracts issued to reinsure another insurance company; and
- (c) Ceded reinsurance premiums = all premiums (less return premiums) transferred to another insurance company for reinsurance purchased.

The NAIC defines "Net written premiums" as the sum of direct written premiums plus assumed reinsurance premiums, less ceded reinsurance premiums.

B. Tax-avoidance Reinsurance Transactions

If a direct underwriter has direct written premiums exceeding \$350,000, then it is not exempt. On the other hand, because of the ambiguous wording of the statute, reinsurers believe that they should be able to cede part of their reinsurance and fall below the \$350,000 mark. IRC 845(b) authorizes the Secretary to make proper adjustments, in the case of any reinsurance contract having a significant tax avoidance effect, with respect to a party to the contract to eliminate the tax avoidance effect.

In determining whether a significant tax avoidance effect exists, the motivation of the parties to the transaction (i.e., their business purpose) is irrelevant. Thus, the Service need not show that the transaction is a "sham." Instead, the Service should examine the economic substance of the transaction, taking into account such factors as the following, as set out in H.R. Conf. Rep. No. 861, 98th Cong., 1st Sess. 1062-64 (1984), 1984-3 C.B. (Vol. 2) 316-18:

- (a) the age of the business reinsured (reinsurance of a new block of insurance contracts has more economic substance than of an old block);
- (b) the character of the business reinsured (reinsurance of long-term insurance has more economic substance than of

short-term);

- (c) the structure for determining the potential profits of each of the parties, and any experience rating;
- (d) the duration of the reinsurance agreement;
- (e) the parties' rights to terminate the reinsurance agreement, and the consequences of a termination;
- (f) the relative tax positions of the parties [emphasis added]; and
- (g) the general financial situations of the parties.

The conference report also lists certain types of reinsurance transactions which generally will be respected. In addition, the report advises that a tax avoidance effect is "significant" if the transaction is designed so that the tax benefits enjoyed by one or both parties to the contract are disproportionate to the risk transferred between the parties.

For example, in TAM 9308003, the Service concluded that two reinsurance agreements entered into by a reinsurance company had a significant tax avoidance effect, and therefore disregarded them in determining whether the company qualified as a life insurance company. The reinsurance assumed had the effect of increasing the life reserves to greater than 50% of total reserves, and thus would have allowed the company to be taxed as a life insurance company had the reinsurance contracts not been disregarded.

As noted above, IRC 845 may apply in the situation where a reinsurer has more than \$350,000 in premiums and cedes some of it to another reinsurer to fall below the \$350,000 mark. The details of the transaction would need to be examined to determine whether the tax avoidance effect is significant, in determining whether the cession of the premiums should be disregarded.

IRC 845(a) provides similar authority in the case of reinsurance agreements between related persons, where necessary to reflect the proper source and character of the taxable income or other tax items of each person. The section also applies where one of the parties to a reinsurance agreement (i.e., the fronting company) is, with respect to any contract covered by the agreement, in effect an agent of another party to such agreement or a conduit between related persons.

Unlike IRC 845(b), a significant tax avoidance effect is not required.

C. Controlled Groups

It is necessary to look beyond the IRC 501(c)(15) applicant itself to determine whether it meets the \$350,000 test. IRC 501(c)(15)(B) provides for the aggregation of the net and direct written premiums received during the tax year by all other companies or associations which are members of the same controlled group. There is no requirement that the other members be insurance companies themselves (i.e., that more than half of their business is issuing insurance contracts or reinsuring risks). If a member receives any net or direct premiums, those premiums are aggregated with the premiums of the IRC 501(c)(15) applicant, even if the member does not satisfy the definition of an "insurance company" for tax purposes.

"Controlled group" is defined in IRC 831(b)(2)(B)(ii), which in turn employs the definition of "controlled group of corporations" in IRC 1563(a) with certain modifications. Under IRC 1563(a), there are three types of controlled groups: parent-subsidary, brother-sister, and combined.

(1) Types

a. Parent-Subsidiary

Under IRC 1563(a)(1) and 831(b)(2)(B)(ii), a "parent-subsidiary controlled group" is any group of one or more chains of corporations connected through stock ownership with a common parent corporation if

- (a) at least 50% of the stock of each corporation (except the common parent) is owned by one or more of the other corporations; and
- (b) the common parent owns at least 50% of the stock of at least one of the other corporations, excluding stock owned by one or more of the other corporations.

Below are three examples of a parent-subsidiary controlled group.

1. Parent

-
- 50%
-
- Sub

See Reg. 1.1563-1(a)(2)(ii), Example (1).

2. Parent

-
- 50% . 50%
-
- Sub Sub
-
- 25% . 25%
-
- Sub

See Reg. 1.1563-1(a)(2)(ii), Example (3).

3. Parent

-
- 45% . 45%
-
- Sub □ □ Sub
- 55%

Reg. 1.1563-1(a)(2)(ii), Example (4). Each sub owns 55% of the other, and such ownership is ignored under IRC 1563(a)(1)(B) in determining the parent's percentage ownership of each sub.

b. Brother-Sister

A second type of controlled group under IRC 1563(a)(2) and 831(b)(2)(B)(ii) is a "brother-sister controlled group," defined as any group of two or more corporations if five or fewer persons who are individuals, estates, or trusts own more than 50% of the stock of each corporation, taking into account the stock ownership of each person only to the extent such stock ownership is identical with respect to each such corporation.

Below is an example of a brother-sister controlled group.

Individuals	Corporations					Identical Ownership
	P	Q	R	S	T	
A	30%	26%	30%	30%	30%	26% (P and Q)
B	26	27	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	26 (P and Q)
C	<input type="checkbox"/>	<input type="checkbox"/>	45	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
D	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	45	<input type="checkbox"/>	<input type="checkbox"/>
E	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	45	<input type="checkbox"/>

P and Q are members of a brother-sister controlled group due to the percentage ownership of individuals A and B. See Reg. 1.1563-1(a)(3)(ii), Example (1).

c. Combined Group

Under IRC 1563(a)(3), a "combined group" is any group of three or more corporations each of which is a member of a parent-subsidary or brother-sister controlled group, and one of which

- (a) is a common parent corporation included in a parent-subsidary controlled group, and also
- (b) is included in a brother-sister controlled group.

Below is an example of a combined group.

Individual

••
51%. . 51%

••
Y Corporation X Corporation

•
50%.

•
Z Corporation

X, Y, and Z corporations are members of a combined group. See Reg. 1.1563-1(a)(4)(ii), Example (1).

(2) Stock Ownership Rules

Under IRC 1563(a), stock ownership is measured by either voting power (the percentage of total combined voting power of all classes of stock entitled to vote) or value (the percentage of the total value of shares of all classes of stock).

IRC 1563(d), (e), (f)(2), and (f)(3) contain constructive ownership rules for attributing stock ownership from partnerships, estates, trusts, corporations, spouses, children, grandchildren, parents, and grandparents for purposes of IRC 1563(a). Under Reg. 1.1563-3(b)(1), ownership of an option to acquire stock is considered as ownership of stock.

IRC 1563(c) excludes certain stock, such as nonvoting preferred stock and treasury stock, from the calculations.

The controlled group rules define control only in terms of stock ownership. This definition creates a problem where a related insurance company is set up as a trust or other noncorporate entity under state law. IRC 7701(a)(3) states that the term "corporation" includes insurance companies--thus, the trust will generally be treated as a corporation for federal income tax purposes if it meets the insurance company definition. However, the controlled group definitions under IRC 1563 are not readily applicable to trusts, which are owned through beneficial interests.

(3) Excluded Members

Certain types of members are excluded from a controlled group. Under IRC 1563(b)(2) (as modified by 831(b)(2)(B)(ii)), a member is excluded if it

- (a) is a member of such group for less than one-half the number of days in the taxable year which precede December 31,
- (b) is exempt from taxation under IRC 501(a) (except a corporation which is subject to tax on its unrelated business taxable income under IRC 511) for such taxable year,
- (c) is a foreign corporation subject to tax under IRC 881 for such taxable year, or
- (d) is a franchised corporation, as defined in IRC 1563(f)(4).

The excluded IRC 501(a) organizations would not include the IRC 501(c)(15) applicant; otherwise, the purpose of the statute would be defeated.

The exception for foreign corporations under IRC 1563(b)(2)(C) is a broad exception, given that many IRC 501(c)(15) applicants are foreign corporations. The apparent purpose of including the controlled group members' premium income into the \$350,000 test is to prevent the avoidance of the dollar ceiling through the use of related corporations. The reason for excluding such foreign corporations as members for IRC 501(c)(15) purposes is not clear, in view of the intent of the statute, which is to exempt only "small" insurance companies. See, e.g., Conf. Rep. No. 99-841, 99th Cong., 2d Sess. II-370-71 (Sept. 18, 1986), 1986-3 C.B. (Vol. 4) 370-71. If the foreign corporation has made an election under 953(c)(3)(C) to treat its income as effectively connected with the conduct of a U.S. business or under IRC 953(d) to be treated as a domestic corporation, however, then it will not be an excluded member under IRC 1563(b)(2)(C).

Under IRC 1563(b)(2)(C), foreign corporations subject to tax under IRC 881 for such taxable year are excluded from the controlled group. Reg. 1.1563-1(b)(2)(ii)(b) defines such an excluded member as a foreign corporation not subject to tax under IRC 882(a) for the taxable year. The key sub-issues are whether the organization is (1) a foreign corporation, and (2) not subject to tax under IRC 882(a) for the tax year.

Reg. 1.881-1(c) provides that the term "foreign corporation" is defined in IRC 7701(a)(3) and Reg. 301.7701-5. IRC 7701(a)(3) provides that the term "corporation" includes associations, joint-stock companies, and insurance companies. Reg. 301.7701-5 provides that a domestic corporation is one organized or created in the U.S., and that a foreign corporation is one which is not domestic.

IRC 882(a) provides for taxation of foreign corporations engaged in trade or business within the U.S. during the taxable year. IRC 842(a) provides for the computation of taxable income of a foreign company carrying on an insurance business in the U.S. The Service has interpreted IRC 1563(b)(2)(C) to mean that a foreign company is excluded from the controlled group only if it is not subject to net taxation under either IRC 882 or 842. The determination of whether an organization is subject to tax under IRC 882(a) or 842 involves some complicated rules, a detailed explanation of which is beyond the scope of this article.

5. What is a "Life Insurance Company"?

In order to qualify under IRC 501(c)(15), an insurance company must not be a "life insurance company." IRC 816 lays out a mechanical formula for determining whether an insurance company is a life insurance company. While it is beyond the scope of this article to provide a detailed explanation of what constitutes a life insurance company, it should be noted that the definition takes into account "life insurance reserves" and "unearned premiums and unpaid losses on noncancellable life, accident, or health policies not included in life insurance reserves." A company is not a life insurance company unless these amounts exceed 50% of its total reserves. Prepaid credit insurance policies which impose no obligation on the issuing company to renew them to age 60 or over, but which are not terminable at the insurance company's option during a lesser period (i.e., the period of the debt) are considered cancellable. Rev. Rul. 60-54, 1960-1 C.B. 266. Credit life insurance reserves may or may not be considered as life insurance reserves, depending on how they are calculated. See Rev. Rul. 69-302, 1969-1 C.B. 186; compare Central Nat'l Life Ins. Co. v. United States, 574 F.2d 1067 (Ct.Cl. 1978).

6. Summary

To be exempt under IRC 501(c)(15) for a given tax year, an organization's primary business must be the issuance of insurance contracts or reinsurance of risks. The contracts issued by captives might not be insurance contracts for federal tax purposes because of a lack of risk shifting and distributing in the contracts. Likewise, service contracts and seller's warranties might not be so characterized because the nature of the contract is primarily not that of insurance. Reinsurers of contracts sold by related persons may under some circumstances be regarded as shams with no substantial purpose other than avoiding taxes on the profits from the contracts. A company in liquidation or rehabilitation may be regarded as an insurance company if claims adjustment and payment is its primary activity and its reserves are reasonable in comparison to its liabilities. Another hurdle for IRC 501(c)(15) applicants is that they cannot receive in the taxable year more than \$350,000 in net or direct premiums, taking into account in this regard both tax-avoidance transactions under IRC 845 and premiums of the members of any controlled group. Life insurance companies, as defined in IRC 816, fail to qualify under IRC 501(c)(15).

To resolve these issues, it is often necessary to look outside of the organization itself and examine closely the business relationships between the organization, its owners, its insureds, and any reinsurers.

APPENDIX

Basic Questions and Answers

1. What are the issues in determining whether an organization qualifies under IRC 501(c)(15)?

An IRC 501(c)(15) organization is one that meets the following basic criteria:

- (1) it issues insurance or annuity contracts or reinsures risks;
- (2) over half of its business is issuing insurance or annuity contracts or reinsuring risks;
- (3) it is a bona fide company and not a sham;
- (4) its net (or, if greater, direct) premiums for the year at issue do not exceed \$350,000, taking into account tax-avoidance reinsurance transactions and controlled group premiums; and
- (5) it is not a life insurance company.

2. What is an insurance contract?

An insurance contract requires a shift of insurance risk from insured to insurer, and a distribution of independent risks by the insurer. Where there is an ownership relationship between the insurer and insured, risk shifting and distributing might be absent. Also, where the contract at issue involves provision of services rather than only payment of money upon the happening of a contingency, or involves only a seller's warranty against inherent defects in a product sold, the contract may not be an insurance contract.

3. What is an insurance company?

Over 50% of a company's business (determined by the facts and circumstances) must be the issuance of insurance or annuity contracts or reinsurance of risks of other insurance companies. Insurance companies in liquidation or rehabilitation are considered to meet this test when their primary activity is adjustment and payment of claims, and their reserves are reasonable in

comparison to their liabilities.

4. What is a sham company?

A sham company is one that has no substantial purpose other than minimizing taxes and that is not carrying on any minimal business activity. A company that reinsures contracts (particularly credit insurance, auto warranties, and chemical protection contracts) sold by related persons often has a purpose to shelter the income from such contracts and should be scrutinized.

5. What are net and direct written premiums?

Direct premiums are those received by the company as the primary insurer, whereas net premiums are the sum of direct premiums received plus reinsurance premiums assumed less reinsurance premiums ceded.

6. What other factors are considered in applying the \$350,000 test?

Short years must be annualized. An insurance company's controlled group members (if any) must be determined and their premiums aggregated for purposes of the \$350,000 test. Also, if a company cedes premiums and the ceding transaction has the effect of lowering the organization's net written premiums below \$350,000, IRC 845 might be used to ignore the transaction under the proper circumstances.

7. What is a life insurance company?

An insurance company is a life insurance company if, during the year at issue, its life insurance reserves and unearned premiums and unpaid losses from noncancellable life, accident or health policies not included in life insurance reserves exceed 50% of its total reserves. Many applications involve credit insurance, which is usually cancelable. Credit life insurance reserves might be life insurance reserves in some circumstances.